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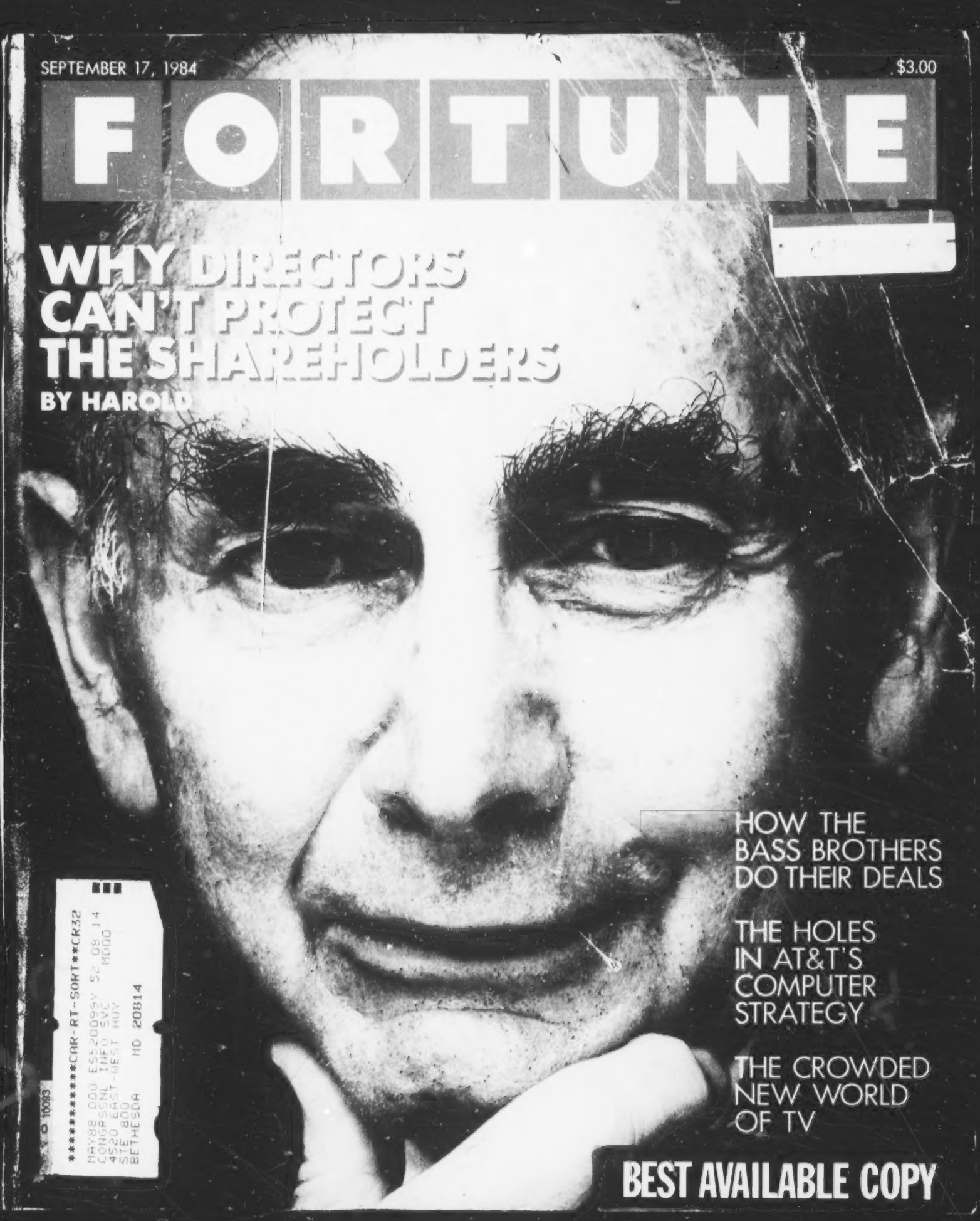
FORTUNE

WHY DIRECTORS CAN'T PROTECT THE SHAREHOLDERS

BY HAROLD



HOW THE BASS BROTHERS DO THEIR DEALS

THE HOLES IN AT&T'S COMPUTER STRATEGY

THE CROWDED NEW WORLD OF TV

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SEPTEMBER 17, 1984 VOL. 110, NO. 6

FORTUNE

During the 17 years he ran ITT, Harold Geneen, photographed for the cover by Alex Kayser, kept his board pretty much under his thumb. Looking back, Geneen thinks that was a bad idea. Excerpts from Geneen's forthcoming memoirs begin on page 28.

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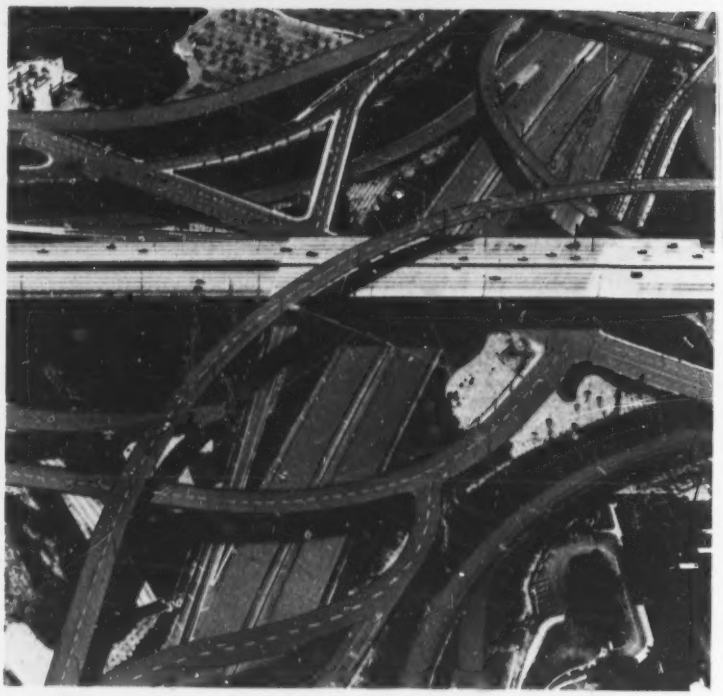
SEEING BEYOND TODAY'S COMPLEXITIES FOR A BRIGHTER TOMORROW



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LETTERS

ly to support a bureaucracy that spews endless statistics to legitimize a corporate presence in South Africa. American corporations are in South Africa to make money in any way they can. They are not in South Africa to be agents for change. They have institutionalized the Sullivan "Principles" as a public relations effort by voluntarily allowing nonwhites to share restrooms and cafeterias with whites. Big deal.

The Sullivan "Principles" have done and will continue to do nothing to change the fundamental structure of apartheid. Almost one-half billion dollars in securities have been divested by institutional investors, and new securities issued by corporations active in South Africa will not be purchased. Divestiture is by far the most important weapon being used to bring real economic pressure to bear against a government whose cancer has lingered much too long.

JOHN C. HARRINGTON
San Francisco

Snail Shortage

The August 6 Editor's Desk left me with a question. If 6,712 metric tons of snails were imported into France in 1982, where are they coming from? My husband is an escargot fan so we always ask for fresh snails in a restaurant. There are none to be had in New York or Washington. And now, apparently, there are very few in France also! Where do the French get their snails? Perhaps there is a market for a budding U.S. entrepreneur.

CHERYL M. KEYSER
Washington

In 1982 the French consumed 23,288 metric tons of their own snails. They imported most of the rest from Turkey, Greece, and Hungary.

Corrections

On its list of the 500 largest industrial corporations outside the U.S. (August 20) FORTUNE gave incorrect sales figures for several companies. In all cases FORTUNE's figures were lower than what the companies recorded. The correct figures and the corresponding sales ranks are: Toyota Motor, $20,608,660,000, No. 5; Sharp, $3,518,501,000, No. 130; Takeda Chemical, $2,081,615,000, No. 231; and Tokyo Sanyo Electric, $1,409,862,000, No. 320.

In addition, other figures should be corrected as follows: Hoechst (No. 19), net income: $287,961,000; Hyundai Group (No. 37), assets: $6,980,047,000; Toyobo (No. 233), employees: 18,300; Dainippon Ink & Chemicals (No. 283), stockholders' equity: $278,192,000; Thyssen-Bornemisza (No. 318), stockholders' equity: $366,000,000; Empresa Nacional del Petróleo (No. 328), sales: $1,388,273,000, assets: $1,146,294,000, net income: $82,722,000, stockholders' equity: $662,084,000.

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FORTUNE

REAGAN'S SECOND-TERM AGENDA

HOW GOOD ARE SECURITY ANALYSTS?

HEWLETT-PACKARD DISCOVERS MARKETING

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President Reagan was photographed for FORTUNE's cover by Alen MacWeeney. A report on what a reelected Reagan would try to do next January is on page 26.

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HOW GOOD ARE WALL STREET'S SECURITY ANALYSTS?

They work hard at understanding their industries, they have great contacts inside the companies they follow, they do tolerably well at forecasting quarterly earnings, and if only they knew how to pick stocks that go up, their customers could all be rich. ■ *by Anne B. Fisher*

SECURITY ANALYSTS are "the royalty of Wall Street," as one brokerage house executive put it recently, and they still command a lot of respect, not to mention salaries that get as high as $500,000 a year for the star performers. But security analysts have a large career problem these days. It centers on the growing suspicion that they're not really very good at what in principle is their main job—helping investors identify stocks that will outperform the market.

That suspicion is, in fact, shared by many brokerage firms which have accordingly redefined the analysts' job. Some firms now put much greater emphasis on a role that the analysts always played to some extent—getting business for the investment banking side. At some other firms they're increasingly viewed as expendable. Hundreds of analysts' jobs have disappeared on Wall Street during the past ten years, and not all of that loss can be laid to mergers among brokerage houses.

So the analysts have an identity crisis. What are they there for? Gerald A. Rothstein, associate director of research at Oppenheimer & Co., is sticking to the traditional view—analysts are there to help investors pick stocks. Generating detailed information about their industries isn't enough, Rothstein says: "The fact that XYZ Co. makes a certain number of widgets a year in a plant is utterly useless unless it affects an opinion on a stock."

Greg Smith, head of research at Prudential-Bache, disagrees. "Analysts spend an incredible number of hours staying on top of their field," he observed recently. "Brokers look to them to be stock pickers, but often they don't have time to study the market. They can't be expected to do everything." Smith is among those who encourage their analysts to bring investment banking business into the firm. An analyst who knows his industry inside out can tell you which private companies in it are mulling over an initial public offering, or which public companies might need some financing, and who might be talking merger. And, given the fees of investment bankers, it may well be that any such business brought in by the analysts would represent a superior return on all that expensive analytical talent.

In any case, more and more brokerage houses seem to be leaning toward Smith's view. Says the head of research at one prominent firm (who asked not to be named): "Analysts need not be right about stocks even half the time in order to fulfill the goals this firm sets out. All we ask is that they bring some business in the door."

Some firms, predictably, don't see why security analysts shouldn't handle both functions—pick stocks and target investment banking business too. Says John Hindelong, head of research at A.G. Becker Paribas, "You like to have a quarterback who can pass *and* run."

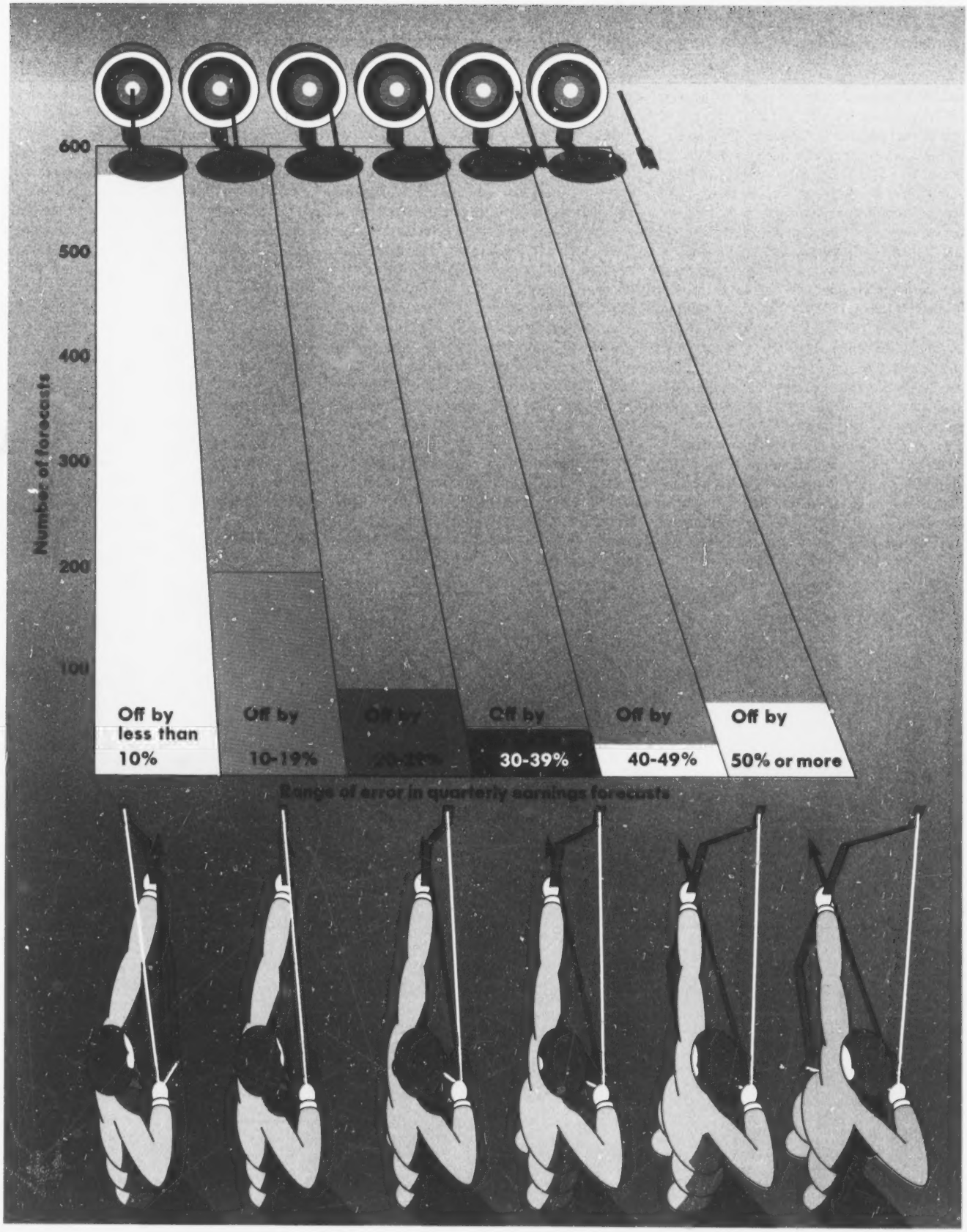
If analysts are generally poor stock-pickers, it isn't for lack of trying. They're typically on the road 15 to 30 weeks out of the year, interviewing managements of companies, haunting trade shows and conventions, and visiting institutional clients. The majority work hard at learning their industries intimately. Michael Culp, a restaurant analyst for Prudential-Bache, jet-hops around the country eating in fast-food emporiums and talking to the people who run them. "Usually they're very suspicious of me," Culp muses. "They think I've been sent from headquarters to spy on them."

Back at the office, analysts face long bouts of number crunching in efforts to come up with earnings estimates. When the numbers are inconclusive, the next move might be to try discreetly checking with the company. The SEC doesn't like companies flatly to disclose their in-house profit predictions to a single potential investor, but it doesn't seem to object to the companies and analysts playing a little guessing game. The analyst will say something like, "I'm projecting you'll earn $1.10." The company executive will reply, "We wouldn't be too unhappy with that number," or perhaps, "You know, our new Wonder Widget hasn't been doing so well overseas as we had hoped . . ." Listening closely to the nuances, the analyst decides whether to add a few cents to his estimate or

RESEARCH ASSOCIATE *Ann Dransfield Louis*

Some Were on Target

Those archers had quite varied results, but the record overall wasn't too bad. The data, compiled by Zacks Investment Research, refer to security analysts' earnings estimates for this year's second quarter. Altogether, Zacks found 1,002 companies for which a consensus forecast could be calculated. In 574 cases, the consensus—the average of what analysts were predicting—was off by less than 10%. Which, to be sure, doesn't mean that investors were making money.



ILLUSTRATIONS BY JOE LERTOLA

knock a few cents off. He then writes his report and, depending largely on what he says about earnings, his firm decides whether or not to recommend the stock to clients.

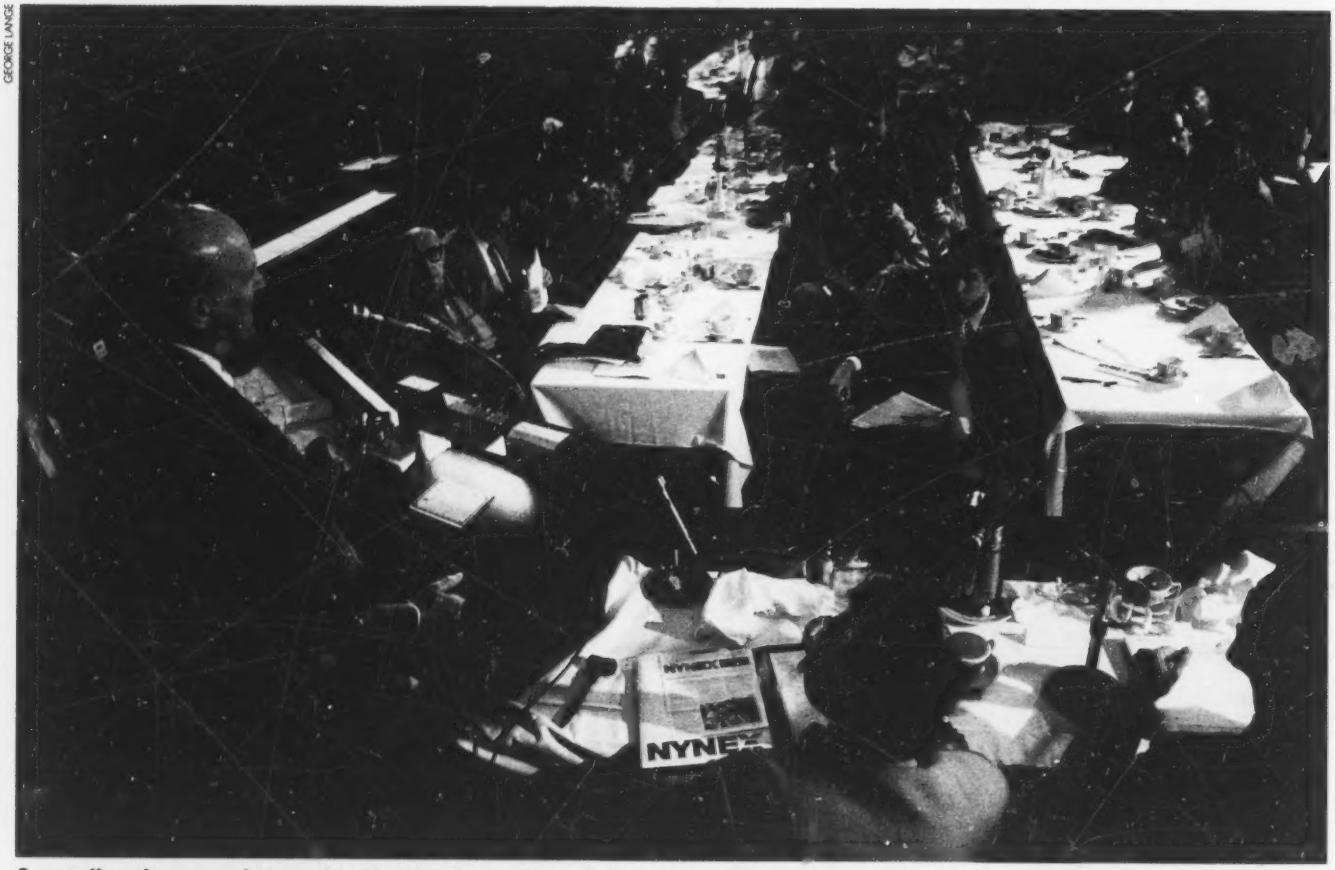
Estimating earnings is hardly an exact science. The luck factor is enormous in many industries. As the chart on the facing page makes clear, few analysts had much luck trying to outguess the oil market last year. On another front, they have underrated CBS recently. The company reported second-quarter earnings substantially higher than most analysts expected. What happened? Among other things, the first-round playoffs in the National Basketball Association went to five games for the first time ever, with the two extra games minting money for the network. And then, just as the second-quarter books were closing, CBS shipped the Jackson family's *Victory* album. At two million records, it was the biggest initial shipment of any album in CBS history. "The best analysts who follow us are as good as we are at predicting earnings," says a CBS executive. "But in a hit-driven business, who can tell?"

It is widely accepted on Wall Street that a good analyst has to stay close to the management of the companies he follows. Unfortunately, some analysts seem to feel, sometimes with reason, that staying close requires them to promote the stock; this would be especially true if the analyst is trying to get some investment banking business for the firm. In any case, closeness can work to undermine analysts' performance. The Baldwin-United debacle last year is a classic example. Most analysts following the company were chummy with Morley Thompson, the courtly and charming former piano salesman who had built the company into a financial services empire with sales of nearly $4 billion. Wall Streeters on a first-name basis with Thompson accepted without question his explanations of complicated tax shelter deals in the company's insurance subsidiaries. A Merrill Lynch vice president who strenuously recommended the stock was regularly spotted flying around the country with Thompson in a company jet. In mid-1982, as Baldwin's earnings and stock price soared, a poll of analysts voted Thompson one of the top C.E.O.s of the year.

But one Baldwin analyst, at least, had never met Thompson. James Chanos, then at Gilford Securities in Chicago, stuck to Baldwin's published data, came to understand the company's Byzantine finances, and concluded that those rising earnings were an illusion created by clever accounting. The outcome has become something of a Wall Street legend. Chanos got himself a big short position in the stock. By the time his colleagues knew what had hit them, Baldwin's share price fell from its high of $50.625 to less than $10. The company went bankrupt last fall.

CHANOS, now significantly richer and based at Atlantic Capital in New York, went against the crowd again in the summer of 1983, predicting that Waste Management's stock, then at $46, was overvalued and due for a tumble. That view put him on highly unfriendly terms with the numerous analysts who were friendly with Waste Management's management. Each of Chanos's "sell" recommendations was greeted by a volley of indignant rebuttals from analysts at A.G. Becker Paribas and

GEORGE LANGE



Spreading the gospel *at one of the New York Society of Security Analysts' monthly luncheons: NYNEX Chairman D. C. Staley*

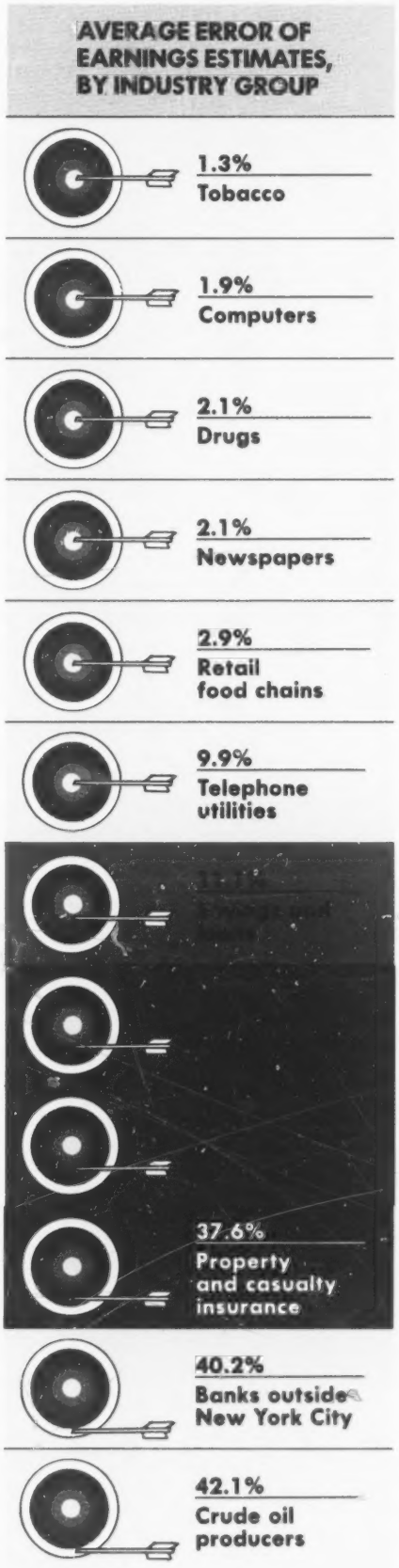
Kidder Peabody. But Chanos is looking good again: in June 1984 the stock touched $27.25. "I don't even go visit companies I'm bullish on," says Chanos. "It's too easy to get blindsided by management." His unpopular method: study only the information the company has to file with the SEC, and eschew those cozy rides in the company plane.

But analysts who stay close to their companies also have stories to tell about the triumphs of their methods. Michael Krasko, a technology analyst at L.F. Rothschild who has followed Texas Instruments for ten years, routinely makes appointments to talk with executives at the company. Last summer, he suddenly observed that he was having trouble making appointments; he couldn't get in to see the head of TI's home computer division at the industry's annual trade show in Chicago. TI President J. Fred Bucy snubbed him too, Krasko recalls. He looked over the company's less-than-lustrous consumer product line and decided that Texas Instruments was probably not long for the home computer business. His pessimistic report, dated June 9, 1983, came out the day before TI's announcement of its expected $100-million loss.

In general, however, analysts haven't done well in the home computer industry. They have been far too eager to believe sanguine managements. Apparently believing that consumers would soon rush to buy home computers by the millions, and that numerous late starters in the industry would be transformed into giants, computer analysts touted the stocks at price/earnings multiples as high as 50. "People were concentrating on the growth rates in these companies," says Duane Kirkpatrick, head of research at Woodman Kirkpatrick & Gilbreath, a San Francisco investment banking firm that specializes in high-tech issues. "If a company's sales are growing at 50% to 100% a year while the economy is growing by 8% or 9%, you are willing to focus on earnings that are far out into the future." But the growth rates collapsed when IBM started to throw its weight around last fall. As a lot of badly burned investors are aware, the share prices of many computer stocks have dropped by 70% or 80%. Did analysts, who are supposed to factor competitive conditions into their earnings forecasts, really think that the biggest competitor of all would let the little guys catch up? One red-faced computer analyst concedes, "We should have anticipated the problem. We got a little carried away."

Tobacco Is Easy

Some industries are harder to forecast than others. In the year ending June 30, the 1,500-odd analysts tracked by Zacks Investment Research were all over the lot, as usual.



In an effort to get past the endless anecdotal examples of failures and triumphs, a number of studies have tried systematically to measure the success of security analysts in forecasting earnings. Unfortunately, the findings of these studies have not all agreed with one another. One study performed by FORTUNE is depicted in the chart on page 131. Based on data from Zacks Investment Research, a Chicago firm that keeps track of analysts' earnings forecasts, it shows that analysts were recently able to predict earnings for the following quarter within 10% more than half the time. The chart at left makes clear that some industries are much easier to forecast than others.

A SCORE of academic studies have also tried to measure analysts' performance. Some of them have found that the analysts don't really do any better in forecasting earnings than you could do with a statistical model that simply extrapolated from past earnings growth. However, the best-known study says the analysts do better than that. This study, performed by professors Lawrence D. Brown of the State University of New York at Buffalo and Michael S. Rozeff of the University of Iowa, was done in 1978 and updated by Brown and others this year.

Their work compared the profit projections of analysts in 11 industries with projections made by a statistical model for all 16 quarters from 1973 through 1976. The model projected earnings by extrapolating past growth rates. In ten out of 11 industries, the analysts were closer to the mark on earnings than was the model. Bottom line: the analysts essentially pay for themselves. That is, an investor who was willing to foot the bill for the work done by a typical analyst could expect roughly to recover his costs in the form of somewhat improved investment results; however, he couldn't expect to do more than recover his costs. Furthermore, the Brown-Rozeff research demonstrated that no analyst consistently outperforms the statistical model. Doing better than the model in one year doesn't predict doing better the next year. Brown's recent addition to the original study used profit data from 1975 through 1980, and reached basically similar conclusions.

The Brown-Rozeff study was essentially concerned with forecasts ranging from one to five quarters ahead. A new study, published earlier this year by professors Sudhir Krishnamurthi of MIT and Michael Sandretto of Harvard, focused strictly on analysts' earnings forecasts made one year ahead—and found that the analysts do very

poorly over this time horizon. The researchers compared 5,477 Wall Street earnings forecasts with actual earnings for the years 1977 through 1981. They found that the average forecast error among the analysts studied was a disquieting 31%.

And picking stocks is even harder than forecasting earnings. The biggest obstacle confronting security analysts trying to pick stocks is probably the stock market itself. Observes Maryann Keller, a star auto analyst who is now a money manager for Vilas-Fischer Associates: "Analysts tend to recommend stocks in a vacuum: this company is good, earnings will rise, therefore the stock will rise. But regardless of how well you grasp the fundamentals of a company—earnings, cash flow, market share, and so on—the market environment can make you a hero or a jerk."

LAST YEAR, for example, many analysts were pushing highly cyclical companies—including railroads, chemical makers, and machinery manufacturers—assuming that they would do well in the strong economy that was expected. In fact, the economy was strong and the companies' earnings have been rising. But their stocks have nevertheless not been in favor: after a brief upturn late in 1983, these stocks basically headed south, underperforming Standard & Poor's 500-stock index so far in 1984. Suresh Bhirud, chief investment strategist at First Boston, puts the blame on uncertainty about the durability of the recovery, and also on excessive caution among investors who were burned in the last recession.

Some analysts will admit privately that they haven't a clue about market movements. "A few weeks ago there were 50 good reasons not to buy stocks," says Barry Good, a veteran oil analyst at Morgan Stanley. "But the market has gone up 130 points since then. Businesses don't change that much in a few days or weeks. The changes are really in psychology. The market has become manic-depressive." He adds, somewhat wistfully: "On any stock, you can pound the table and insist that technically you are right. But the market doesn't give a damn."

Given these high levels of uncertainty, analysts' forecasts tend to be hedged, and even downright cryptic. Remember when a stock was rated either "buy" or (much more rarely) "sell"? Those simple days are over. A rating scale typically sports five categories, which might, for example, be: buy, okay to buy, neutral, okay to sell, and sell. To add to the general murkiness, lots of recommendations combine more than one rating, such as "short-term neutral, long-term okay to buy." As one portfolio manager somewhat cynically notes, "If nobody knows what you meant, they can't say you were wrong." Rating a stock neutral means never having to say you're sorry.

The endless variations in rating nomenclature offer another advantage: it's hard to contrast the stock-picking performance of different firms. An "okay to sell" from Merrill Lynch may not be strictly comparable to a "swap" from Smith Barney. Or then again it may.

> It's no wonder Goldman Sachs is eager to talk. Investors hewing to its recommendations had higher returns than the Dow in each of the last six years.

In an attempt to discover whose analysts have the best stock-picking records, FORTUNE asked some major brokerage houses for records on the stocks they've recommended in the last few years. Merrill Lynch, First Boston, Smith Barney, Kidder Peabody, and Morgan Stanley all declined to share their records, although several of them allowed that they track their own performance closely. Executives at two of the firms cited a New York Stock Exchange rule against flaunting one's record. According to an attorney at the Exchange, however, there is no such rule, so long as the record covers at least one full year—and so long as it consistently tracks a specific universe of stocks, with no embarrassments omitted.

A number of other firms were forthcoming. It's no wonder that Goldman Sachs is eager to talk. An investor who hewed to the firm's recommended list, buying the stocks Goldman touted and selling the issues that dropped from Goldman's favor, would have reaped a higher total return (price appreciation plus dividend yield) than both the Dow Jones industrial average and the Standard & Poor's 400 in each of the past six years. Data provided by Salomon Brothers show that its picks have beaten the S&P 500 for the past two years. Drexel Burnham Lambert wouldn't disclose results for all the stocks it has recommended, but it's delighted to tell you that during the past year its "Priority List"—consisting of all those stocks rated strong buys—has had a total return of 21.4%, vs. 6.7% for the S&P 500.

Oppenheimer supplied figures on a different basis. Its data show that an investor who painstakingly followed Oppenheimer's recommended list would have seen his portfolio appreciate by more than the market in each of the past nine years. Shearson Lehman/American Express invites you to concentrate on certain long-run figures. The firm rates its own performance using a hypothetical stock portfolio that has existed since 1949. Of the 350 issues recommended since then, 228 have gone up, 112 have slipped, and ten didn't change at all during the period they were on the list.

Value Line, historically among the most respected of stock pickers, disappointed its followers in the first quarter of 1984, when the firm's top-ranked buy recommendations lagged behind the Dow. If, however, you had consistently bought their top-ranked stocks and held them for at least a year, you would have multiplied your capital more than 11-fold from 1965 through June 1984.

PRUDENTIAL-BACHE HASN'T been doing so well. This year the stocks it rated "1," which means "buy," underperformed the S&P 500. Even more mortifying, the seven stocks singled out for "5," or "sell," ratings collectively outperformed the market.

So the record would seem to show about what you'd expect: some analysts have been doing well in recent years, some have done poorly, the ones who are most eager to share their records with you generally seem to do quite well, and almost everyone tends to structure the performance record in ways that make the firm look best. All in all, the record doesn't really refute the widespread suspicion that security analysts aren't very good at picking stocks.

That doesn't mean, however, that Wall Street would be a better place without the analysts. If they didn't exist, the market would presumably be much less efficient, and investors would have much less reason to believe that their stocks are reasonably priced. In gathering and disseminating huge gobs of information about companies and stocks that investors wouldn't otherwise have, the analysts over the long run help to ensure that stocks are fairly valued. Maybe that's all we can ask of them. F

new stock at the equivalent of about $8 per Centex share. Centex recently sold at $25.50, which implies a market valuation of $17.50—just above book value—for the rest of the company. That's only eight times the $2 to $2.25 that Millman of Rothschild Unterberg Towbin expects Centex without Cenergy to earn this year. It's also considerably less than half the $40 to $45 that Garrison of Lovett Mitchell Webb figures the company's assets are worth.

Ma Bell's Offspring Are Ringing Up Profits

■ On the basis of corporate earnings reports so far in 1984, Wall Street analysts have been revising many earnings projections downward for both this year and next. But those who follow the Bell operating companies have been doing just the opposite. Most of the regional holding companies created by the breakup of AT&T reported stronger than expected earnings for the first half of this year. Impressed by the companies' success in holding down expenses—not generally thought to be a forte of monopoly enterprises—analysts are now more confident that these companies will prosper in their new environment.

In response to good performance, stock prices of the AT&T spinoffs climbed some 11% in July and August. This climb has led some former ardent supporters of these equities, such as Ernest Liu of Goldman Sachs, to tab them as fully valued. The basic concern is that interest rates will rise, and that then the 8.6% yields now offered by the telephone stocks will no longer look attractive to income-oriented investors.

A number of analysts, though, are recommending the stocks. Edward Greenberg of Sanford C. Bernstein downplays what he considers to be undue emphasis on their sensitivity to interest rates. He argues that the Bell operating companies "are about the highest-quality utilities you can find." Charles Schelke of Smith Barney points out that most of the stocks still sell at a discount from book value and at a lower multiple than the S&P 500. He anticipates rises of 20% to 30% in their prices over the next year.

The earnings outlook is positive even though the companies face new competition in their yellow pages business (see Selling). Demand for telephone service is expected to remain buoyant, and over the last year or so

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COMPANY	FIRST-HALF REVENUES in millions	NET INCOME in millions	STOCK PRICE RANGE	RECENT PRICE P/E multiple[1]
Ameritech	$4,101.3	$521.5	$62.125–$74.00	$72.50 7.3
Bell Atlantic	$3,981.1	$482.1	$65.00–$76.25	$74.75 7.5
BellSouth	$4,623.0	$568.4	$27.25–$32.75	$30.87 7.7
NYNEX	$4,638.9	$461.3	$58.625–$70.50	$68.75 7.2
Pacific Telesis	$3,772.7	$408.7	$51.25–$63.875	$61.87 7.7
Southwestern Bell	$3,466.5	$417.1	$55.00–$65.00	$63.50 7.3
US West	$3,542.9	$406.0	$55.125–$65.125	$61.00 7.0

[1]Based on earnings estimates for 1984 compiled by the Institutional Brokers Estimate System

Doing All Right on Their Own

The stocks of the Bell operating companies have far outperformed the market since they began trading last January. Analysts predict that strong earnings will propel the stocks to new highs.

most state commissions have been reasonable in allowing rate increases. In addition, some analysts expect that long-distance carriers will soon have to pay local telephone companies more for access to local lines. And higher earnings, Wall Streeters point cut, imply higher dividends. Greenberg of Sanford C. Bernstein foresees 1985 increases of at least 5% for all the companies, with some—**Ameritech, Bell Atlantic, NYNEX**, and **Pacific Telesis**—able to raise their dividends by more than 10%.

So far, says John Bain of Shearson Lehman/American Express, "there is no burning case for buying one versus another." Other analysts agree. Says Liu of Goldman Sachs: "For now, investors must view all seven as very highly regulated local phone companies." Though the seven companies are diversifying, they are moving in much the same direction. All of them are marketing phone equipment and providing mobile phone service. Some differences between the companies are beginning to emerge but won't have much impact right away. **US West** has set up a subsidiary to develop commercial real estate. Pacific Telesis plans to go into real estate management. Ameritech has formed a partnership with seven other companies to offer burglar and fire alarm services to its Wisconsin customers. US West and Bell Atlantic are establishing subsidiaries that will buy telecommunications equipment and lease it to customers who prefer not to purchase equipment of their own.

Even now the seven operate in different regulatory environments. Because Pacific Telesis, for example, derives 95% of its revenues from phone service in California, any decision of that state's rate commission significantly affects the company's earnings prospects. Fortunately for Pacific Telesis, California's regulators have recently eased their tightfisted attitude. US West, with operations in 14 states, and **BellSouth**, in nine, might be called politically diversified.

The markets the companies serve are also diverse. NYNEX's heavy reliance on nonresidential customers—fully one-third of its revenues are generated in the southern half of Manhattan—is a mixed blessing. While such service provides nice profits, NYNEX's business customers, says Mark Luftig of Salomon Brothers, are targets for independent telecommunications companies.

With analysts unable to single out individual stocks despite emerging differences among the companies, some suggest that it might be reasonable to go with the cheapest. According to figures put together by Bain of Shearson Lehman, the companies selling at the lowest multiples of estimated 1984 earnings are Ameritech, **Southwestern Bell**, and Pacific Telesis. But Bain cheerfully says, speaking of all seven companies: "These are all fine investments for individuals."